Banking Developments
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Developments in Private Equity Investments in Banks

Private equity firms have a large amount of committed capital to invest, and want to invest in banks. The banking industry needs additional capital. The Federal Deposit Insurance Corporation (FDIC) needs the industry to obtain additional capital. The US and global economies need strongly capitalized banks to re-open the lines of credit that keep business moving and the economy stable or growing. Existing relatively healthy banks do not have sufficient capital to acquire the troubled banks. Over one hundred US banks have failed in 2009 and estimates suggest another 250 to 1,000 may fail in the next two years. The FDIC recently estimated that it will need approximately $100 billion to resolve failing banks over the next few years.

On August 26, 2009, the FDIC issued a "Final Statement of Policy on Acquisition of Failed Depository Institutions." This FDIC Policy Statement relates only to acquisitions of failed depository institutions, and not to investments in solvent banks, true *de novo* banks, or otherwise not involving an FDIC receivership. It imposes significant restrictions on private equity investments in banks acquired from the FDIC as receiver. Among these are:

1. Higher than normal capital requirements;
2. A "cross support" requirement that groups of investors that own more than 80 percent of the acquired bank and another bank pledge the shares of the other bank to the FDIC (this is in addition to the Federal Deposit Insurance Act's "cross guarantee" provision);
3. Restrictions on transfer;
4. Affiliate transaction restrictions; and
5. Additional acquiror disclosures to the FDIC.

The past 18 months have seen surprisingly little in the way of private equity investment in banks. That may be about to change. The federal banking regulators have settled on a paradigm that allows private capital to flow into banks, while addressing concerns about the role of private equity funds owning banks. In addition, the agencies are looking at various structures by which private equity will be allowed to invest alongside banks, the FDIC or other government agencies in loans, real estate, or other assets spun out of banks, without investing in the bank itself.

The new paradigm for investment into banks is the "management-led" transaction. This is a bank-centric transaction, in which the bank's management team pulls together the deal and is clearly in charge of running the bank. The management-led structure differs from two other structures: the "silo" transaction (in which individuals who own a private equity firm form a fund to acquire banks), and the "club deal" (in which several similarly-minded private equity funds put together a deal to acquire large, but under 25 percent, voting positions in a new holding company that will acquire one or more banks and fill most of the board seats). The difference is who is running the show. In the management-led transaction, a cohesive team of senior bank management professionals clearly are in charge and are the impetus for the transaction and will be running the bank. A majority of the bank's board of directors are persons who are not associated with the private equity funds. In the silo fund and club-deal structures, one or more private equity funds are the impetus for putting together the transaction, and a majority of the board of directors may be the private equity investors (although generally not more than one or two directors from any one investor group).

The "management-led" structure is the confluence of three different approaches put forward by the regulators over the last year: the September 2008 Federal Reserve Policy statement [12 C.F.R. 225.144] (which clarified limits on the percentage that any one private investment fund can own and the activities it can conduct without being deemed in "control" of a bank or bank holding company); the "shelf-charter"/pre-clearance approach of the Office of Thrift Supervision and Office of the Comptroller of the Currency (which recognized the need to find a way to re-capitalize the banking industry); and the FDIC's 2009 Policy Statement.

When structured with these principles in mind, it is anticipated that private equity can be a significant source of new capital to the banking industry. This will help shore up banks that need additional capital but are fundamentally sound, provide capital to acquire banks out of FDIC receivership, and create new banks to provide lending and other services.